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Even if You're Private: What You Should Know About Sarbanes-Oxley

What initially only seemed to affect public companies is also having far reaching implications on corporate America as a whole.

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Introduction

The Sarbanes-Oxley Act of 2002 (SOx) is the most far reaching legislation affecting the federal securities laws since they were created in the 1930's. It impacts everything from the role of auditors to public reporting of stock trades by management, from committee independence to reporting of off-balance sheet transactions, and from officer loans to employee whistle blowing.

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SOx significantly increases penalties for white-collar crimes such as securities fraud, with maximum jail terms that now exceed the penalties for crimes such as armed robbery, assault with a deadly weapon and negligent homicide. SOx also created several new crimes: retaliation against whistleblowers; destruction of documents and other obstruction of justice offenses; fraudulently influencing the company's auditors; and a new substantive securities fraud offense.

Public companies are facing dramatic changes in disclosure and corporate governance requirements under the SOx, and under new and proposed rules from the SEC, NASDAQ and the NYSE. While these new rules and regulations do not generally cover private companies, their influence on private companies is being felt in the following ways:

- SOx may result in increased scrutiny of a private company being considered for acquisition by a public company.
- A private company will become subject to SOx upon filing a registration statement with the SEC in anticipation of an IPO.
- The boards of directors and management of many private companies are embracing various aspects of SOx as "best practices."

Familiarity with these new rules will help private companies avoid pitfalls that could interfere with important future milestones, such as an acquisition or an IPO, and will contribute to the foundation of a company culture of fiscal and corporate responsibility.

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Board of Directors and Board Committees

Private companies should be aware of the rules relating to the composition of a board of directors and board committees, and should be prepared to be in compliance with these rules prior to filing an IPO registration statement. Of particular importance will be the need to have qualified independent directors—a requirement that will become increasingly difficult to satisfy, as increasing legal risks and director responsibilities, as well as increasing financial expertise requirements, could diminish the pool of willing-and-able participants.

Key Concept	Board Independence: Proposed NASDAQ and NYSE rules require that at least a majority of the directors be independent.

Audit Committees. SOx and stock exchange rules impose heightened requirements for audit committee composition and impose additional responsibilities on the committee:

Independence. SOx, NASDAQ and the NYSE each require that all members of the audit committee be independent. Of note is a proposed NASDAQ rule that would prevent 20% stockholders from being considered independent, which may disqualify some of a company's venture capitalist directors from serving on the audit committee. A proposed SEC rule would provide that persons owning less than 10% of a company's stock would not be precluded from being considered independent for audit committee purposes by virtue of their stock ownership.

Financial Expertise. Current NASDAQ and NYSE rules require all audit committee members to be financially literate, and at least one member to have accounting or financial management experience. SOx requires companies to disclose in their Form 10-Ks whether the audit committee is comprised of at least one member who is an "audit committee financial expert." The SEC's definition of audit committee financial expert requires that the person have specified accounting expertise that is generally acquired either through experience as an accountant or as CFO or controller, or through experience supervising such a person.

Responsibilities. The audit committee has the direct and sole responsibility for the appointment, compensation and oversight of the company's auditors. The audit committee is also responsible for pre-approving audit services and any non-audit services not prohibited by SOx.

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Accounting Complaint Policy. SOx requires that the audit committee adopt and implement procedures for receiving and handling complaints regarding accounting matters, including the confidential and anonymous submission of employee concerns regarding accounting matters. Compensation Committees. Both NASDAQ and the NYSE have proposed that compensation committees must consist solely of independent directors.

Nominating Committees. NASDAQ has proposed requiring that all director nominations be approved by a nominating committee consisting of independent directors or a majority of all independent directors. The NYSE has proposed that each listed company must have a nominating and corporate governance committee consisting solely of independent directors.

Relationship with Auditors

Prohibition of Certain Non-Audit Related Services. The accounting firm performing a public company's audit is prohibited from performing specified non-audit services, including bookkeeping, appraisals, valuations, financial information systems design and implementation, investment advisor services, actuarial services, fairness opinions and human resource services. If a private company is receiving any of those services from its auditor, the company should be prepared to obtain those services from another party upon the filing of an IPO registration statement. Tax services are still permitted.

Rotation. The lead audit partner and the concurring review partner must be rotated at least every five years, and certain other partners involved in the audit must be rotated every seven years. Thus, a private company beginning the IPO process with an audit partner it has had for four or more years may see that partner rotate off the company's account during or shortly after the IPO process.

Restrictions on Hiring from Accounting Firm. An audit firm is not independent if a company's CEO, CFO, chief accounting officer or controller (or another person in a "financial reporting oversight role") is a former employee of the audit firm who worked on the company's audit during the past year. Therefore, a private company should be careful hiring from its accounting firm during the year before it intends to file an IPO registration statement.

Year-end Audit Crunch. Private companies that are venture-backed or have bank loans are typically required to provide investors or the lender with audited financial statements within 90 days after the end of the fiscal year. Frequently, private

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companies experience difficulty getting accounting firms to complete an audit any time between January and the end of March, given the Form 10-K filing deadlines for public companies with calendar fiscal year ends.

Recently adopted SEC rules will require that public companies file Form 10-Ks in an even shorter time frame following fiscal year end. This change, combined with the increased disclosure requirements for public companies, will likely make it more difficult and costly for private companies to complete their audits within the required time frame. Private companies concerned about this "audit crunch" should discuss this with their auditors and, if necessary, could change their fiscal year ends so that annual audits are performed later in the calendar year.

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Disclosure Controls and Internal Controls

Perhaps no aspect of SOx is more dramatic than the new requirements for CEOs and CFOs to personally certify their companies' annual and quarterly reports. Companies are now introducing and updating a wide range of processes designed to ensure that information is identified and disclosed in a timely and accurate manner.

The SEC codified the need for these processes through new rules requiring public companies to maintain "disclosure controls and procedures"—that is, controls and other procedures designed to ensure that information required to be disclosed by the company in its SEC reports is assimilated and processed within the required time periods—as well as to periodically evaluate them and report on their effectiveness. The SEC has proposed similar rules regarding "internal controls and procedures for financial reporting"—that is, controls regarding the preparation of financial statements for external purposes that are fairly presented in conformity with GAAP.

Any potential public company acquirer will likely want to conduct significant due diligence on the private company's controls and procedures and will insist on representations in the acquisition agreement covering those controls and procedures. This will be necessary to help ensure that the acquirer is in a position to make the required statements and certifications in its SEC filings with respect to its own controls and procedures—which, following the acquisition will subsume and depend in part upon the controls and procedures of the private company. A private company may face a similar level of scrutiny by a potential acquirer that is seeking to go public or be acquired by a public company. Moreover, having

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controls and procedures in place that approximate those required by the SEC is a sound business practice.

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Also, any private company planning to go public should have a level of controls and procedures in place that will enable it to comply with these SEC rules. The underwriters of a company's IPO will almost certainly scrutinize the company's controls and procedures as part of their due diligence process.

Covenant Creep

As banks, institutional investors, insurance companies and service providers change their standard forms and operating procedures in response to this changing regulatory environment, some of their new practices and the covenants, representations and warranties that they will require of public companies will inevitably begin to impact private companies. For example, investors in private companies may begin to require audit committees to comply with the membership rules applicable to public companies, and insurance companies may introduce new obligations based on heightened corporate governance standards.

Prohibition on Personal Loans

SOx prohibits public companies and companies in registration for an IPO from extending, maintaining, renewing or arranging personal loans to any director or executive officer. Loans that existed on July 29, 2002 are permitted to remain outstanding, so long as they are not materially amended. Upon the filing of an IPO registration statement by a private company, all outstanding loans made after July 29, 2002 to a person who is a director or executive officer of the company at the time of filing will be illegal.

Private companies should consider prohibiting loans to officers and directors or requiring that any loans made or modified after July 29, 2002 be repaid immediately prior to the filing of an IPO registration statement if at that time the borrower is a director or executive officer. In addition, private companies should consider adding, as a condition of a loan, the requirement that an acquisition of the company by a public company be considered as triggering repayment of the loan, if the borrower becomes a director or executive officer of the acquiring public company.

Private companies should bear in mind that the company might have to forgive such a loan upon the filing of a registration statement, since repayment may not

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be practical given that there will not yet be a public market for the company's stock at the time the loan must be repaid. Also, forgiving loans extended for the purchase of stock may result in unfavorable accounting treatment.

Private companies should take this opportunity to implement best practices and adopt a company culture that is less susceptible to the problems that prompted the enactment of SOx.

Stockholder Approval for Stock Plans

The NYSE has proposed a rule prohibiting discretionary voting by brokers on stock plan proposals and instead allowing brokers to vote customer shares on stock plan proposals only pursuant to customer instructions. Although this is a NYSE rule, it would affect NASDAQ companies as well, since it would apply to voting by all brokers and dealers that are members of the NYSE, regardless of whether the shares being voted are shares of a NYSE-listed company.

This rule change may make it significantly more difficult for public companies to obtain stockholder approval of stock plans. This issue underscores the need for a company contemplating an IPO to evaluate whether it needs to increase the number of shares covered by its employee stock option plan and whether it wishes to adopt any new stock plans—such as a director stock option plan or an employee stock purchase plan—and to obtain the necessary stockholder approval for any such plan amendment or new plan while it is still a private company and stockholder approval is easier to obtain.

Summary

Becoming familiar with the new corporate governance and disclosure rules applicable to public companies will help a private company prepare for an acquisition by a public company or an IPO. In addition, private companies should take this opportunity to implement best practices and adopt a company culture that is less susceptible to the problems that prompted the enactment of SOx.

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